HollAnd
Advisors

HOLLAND ADVISORS/FARNAM STREET CAPITAL INVESTMENT APPROACH

Our job as managers of an investment fund with other people's and our own savings invested in it, is to protect that capital and try to ensure that it grows at the best possible annual rate, whilst not assuming an unacceptable level of risk. We strive to think like long-term business owners and to find the same mind-set in the investors we attract and the company managers we invest with.

HOW WE THINK ABOUT INVESTING

- We enjoy it!
- We think it is a puzzle to be worked out.
- We always want to be learning and we strive to get better at it over time.
- We view it as a science that requires accuracy, patience and professionalism, but also a craft that calls on experience and judgement.

We think there are a number of must-knows in investing. Some are self-explanatory, but some are worth expanding upon:

- You must know to always invest with a margin of safety.
- You must know who Mr Market is.
- You must know how to value a business, independent of any market quote.
- You must know what you are looking for.
- You must know your limitations.

KNOWING WHAT YOU ARE LOOKING FOR

The types of companies we look for fulfil our definition of a 'Franchise'. Such companies:

1. Make high returns on capital
2. Operate in a good industry
3. Grow
4. Have good businesses models ensuring some form of moat
5. Are well managed and allocate capital well

- Such companies can therefore be expected to compound their intrinsic value per share at attractive rates over time.
- Whilst we may be excited to discover a company excelling in all of these fields, we try not to fall in love with any of them.
- We are mindful that companies (like investment funds and central banks) are all run by human beings – who make mistakes, sometimes fail and can also change their minds.

We also like businesses:

- Which we can understand.
- Where we have an idea of what they may earn in 3 or 5 years' time.
- Where much of what we need to know can be learnt from understanding a company's past, rather than needing to predict its, perhaps uncertain, future.

About Management:

- Many great CEOs share similar traits and these are common across diverse sectors.
- We like long-standing owner managers.
- There are many great 'operator' CEO's but we also need ours to allocate capital well.
- Management's incentives should be aligned with the funds.
- If we don't trust the management we don't buy the shares. Ever.
- Many CEO's are very good at selling their Company's story and like to make acquisitions.
- But, most acquisitions are unsuccessful if judged on their investment return.

What type of investments do we look for

- There is a distinction between a good company and a good investment – the determining factor is price.
    - Our preference is to find enough 'franchises' at compelling valuations to fill a whole portfolio.
    - But where that is not possible we will not make up a portfolio of similarly good companies selling at less compelling prices.
    - Instead we will do one of the following:
        1. We will look at 'Special Situations' either that offer exceptional value and/or where franchise characteristics can emerge ('ugly ducklings' that become 'swans').
        2. Look at deep-value situations if we feel we are compensated for the risk.
        3. Look for 'Work Out' opportunities that provide attractive returns in short-duration assets that have a lower correlation to markets.
        4. We will also own cash – A much underrated asset class, we believe, due to the value of the optionality it brings.
- We like companies that are under-earning vs. their long term rate and under-priced vs. the appropriate valuation for their business model.
- We like value that is not in plain sight due to accounting or managerial prudence.
- We like companies and sectors disliked or overlooked by others.

How to value a business

- A businesses value is a function of its cash flows, not what someone will pay for it.
- We look for absolute, not relative, value in the investments we seek:
    - But we adjust for quality, liquidity and predictability.
- Many metrics can drive a future business valuation, but the returns it makes on its capital, its needs and usage of that capital and the business growth rate are the biggest drivers.
- We look for companies that compound their intrinsic value per share at an attractive, but sustainable rate.
- We consider what we think is the most likely intrinsic value growth rate, the level of any undervaluation and what could go wrong.
- We then compare today's offered value to those outcomes.
- We don't make too detailed or unrealistic projections of the future to derive value and we don't use other people's forecasts.

Our long term annual return target

- Whilst we accept that any target rate of return will never be delivered in a smooth manner, we believe giving such a rate can help investors better understand the fund and what it seeks to achieve.
- Whilst not easy, we believe it is possible (and we seek) to find companies that can grow their intrinsic value per share at c.12-14% annually.
- Investing in such companies at a lower price than justified by their business model should increase such a return at the portfolio level.
- Equally, being underinvested by owning too much cash would reduce it.
- A similar annual fund return target is thus possible if enough quality investments can be found. So we think it is reasonable to have a long term fund target return of greater or equal to 13%pa.

Compounding

- We agree with Albert Einstein that compounding is the 8th Wonder of the World.
- A few annual percentage points difference in any investment's return, due to either underlying investment success or over-charging, can have a big impact over time.
- Hence we only charge what we consider fair, success orientated fees.
- We are very aware that if the fund, or any other investment, were to grow at 8%, 12% or 16% pa. an investors' money would double every nine, six or four and a half years respectively.
- We try to accept when we have made a mistake so as to release capital and give us another go at compounding in a new investment.

How we structure our portfolio

Position sizes

- We believe that far too many investors are so diversified that they can only ever achieve average (or below average) returns.
- Nearly all the great investors we have studied run concentrated portfolios, thus maximising their returns.
- We too want to own a small number of exceptional investments, thus maximising our portfolio return:
  - But we like to sleep well at night and so strike a balance.
  - As a result we often have approximately 20-30 investments.

Our attitude towards leverage

- We liken leverage to a loaded gun. Those that use it need to be highly trained and trusted, be they fund managers or company CEO's.
- We do not use leverage in the portfolio. Mostly we sit on cash balances.
- We assess companies without the benefit they might accrue from leverage.
- Often the majority of the investments we make are in companies with little or no leverage.
- Those that do have it, we assess can stand the burden it brings in all economic scenarios.

Risk

- Risk is not expressed as a letter in the Greek alphabet, but is the real risk of *permanently* losing a portion, or all, of one's invested capital.
- Quoted investments can at times be volatile but we believe a few traits can reduce the likelihood of a temporary quoted investment loss becoming permanent:
    - The quality of the companies' business model and the price paid.
    - A good ethical manner in the way a company conducts its affairs.
    - Low financial gearing.
    - A low starting point in operational gearing i.e. investing when margins are below the likely future rate, not above.

Derivatives

- We will occasionally invest in long dated warrants or options when we think they provide us a geared return to a situation that we have high confidence in.
- Otherwise we will rarely use derivatives and do not sell shares short.

How we think

- At the outset of a new opportunity we try to be contrarian and open-minded.
- Thereafter we try to be disciplined.
- We use robust checklists containing ours and others' past mistakes to test the quality of what we have found and to try and avoid cognitive biases.
    - For example, one of our questions is 'Are we thinking carefully or excitedly'?
- We try to think in business models and mental models not in sectors and believe transferring these models across different industries and geographies brings real advantages.
- We are building cumulative knowledge on companies, industries and business models that should continue to help our analysis into the future.

What we consider our advantages

- That we love what we do so have the energy to work hard.
- That our approach has been well proven by some great investors.
- That we are inherently trying to find companies who are compounding at strong growth rates.
- That we are far removed from stock market noise and institutional/committee-type processes.
- That we have mental models and checklists helping us recognise when we have seen something similar before.
- That we know exactly what we are looking for.

And disadvantages

- We are small and thus less well plugged into markets.
    - As a result we may miss some 'market-info' type knowledge
- We do not have significant sector expertise in-house.
- Our size and distance from some of the companies we invest in <u>may</u> mean others will have better knowledge of/and access to management than we have.

Other

- We are happy to be great copiers rather than innovators.
  - We will copy an investment approach if we think it has genuine merit.
  - We are not proud as to where an investment idea originates. Another smart investor may have seen something we have not, but we always do our own work.
- We value our reading glasses more highly than our Bloomberg terminal.

Macroeconomic Wing Mirrors

- We are not top down investors, looking mostly for value at the individual company level.
- But we keep our eyes open for trouble in the asset classes or sectors we are invested in.
- We liken the economic backdrop to wing mirrors in our car i.e. we mostly look out of the front window for mispriced quality investments, but like any good driver keep an eye on our mirrors.

"Price is what you pay – Value is what you get". Warren Buffett

Andrew Hollingworth, September 2014